TEACHERS' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Update on Federal Legislation ITEM NUMBER: 5b

ATTACHMENT(S): 4

ACTION: X MEETING DATE: October 3, 2002

INFORMATION: ___ PRESENTER: Ed Derman

Now that Congress has reconvened, the House and Senate continue to develop and review legislation in response to the Enron and WorldCom debacles. In addition, agency regulatory efforts continue to make progress in drafting new proposed regulations. The legislative measures are summarized below and regulatory measures that are now being evaluated are discussed in greater detail in the attached reports.

INVESTOR PROTECTION AND ACCOUNTING OVERSIGHT LEGISLATION

On July 25, Congress enacted the Sarbanes-Oxley Act of 2002 with an overwhelming majority and President Bush signed it into law on July 30. The Sarbanes-Oxley Act is the most wide-ranging securities reform legislation enacted since the 1930's. During the course of the passage of the Sarbanes-Oxley Act, CalSTRS was very active in lending its support for this important piece of legislation. CalSTRS submitted four letters to Congress regarding the necessity of passing this important corporate governance measure. The attached report describes the Sarbanes-Oxley Act of 2002 in greater detail.

Although the Act is now law, many of its provisions will be affected by subsequent developments. Some corporate governance provisions may eventually be surpassed by efforts currently underway by the stock exchanges and NASDAQ as they work to impose more stringent requirements. Summaries of these activities are also attached.

PENSION SECURITY LEGISLATION

House Legislation

On April 11, the House of Representatives passed H.R. 3762 (the Pension Security Act of 2002), the first piece of legislation in answer to the Enron debacle. This legislation melded together competing versions of the measures developed by the House Ways and Means Committee and the Education and Workforce Committee. Many of the bill's provisions addressed concerns raised by the Board. According to the official description, the key provisions of the Pension Security Act of 2002:

- Require the Secretary of Treasury to issue guidance and model notices that include the value of investments, the rights of employees to diversify any employer securities and an explanation of the importance of a diversified investment portfolio
- Ensure that all employee contributions to pension plans will be immediately diversifiable
- Provide for the option of a rolling three-year diversification of employer securities, plus a five-year transition rule for the allowable diversification of employer securities held in individual accounts
- Permit employees to be able to use pre-tax dollars to obtain their own investment advice
- Include a blackout provision during the changes of a plan administrator (A similar provision has already been enacted as a part of the Sarbanes-Oxley Act and may be dropped from the final version of the Pension Security Act)

Senate Legislation

Senate Majority Leader Tom Daschle is coordinating efforts to meld together competing versions of the pension security legislation reported out by the Senate Health, Education, Labor, and Pensions Committee (S. 1992) and the Senate Finance Committee (S. 1971), which has jurisdiction over the tax rules governing pension plans and shares jurisdiction over ERISA with the Senate Labor Committee.

Majority Leader Daschle and Senate Finance Chairman Baucus are considering adding a package of small business tax breaks intended to be part of an increase in the minimum wage as well as legislation addressing corporate "inversions" (S. 2119), in which the U.S. parent company of a corporate group reincorporates offshore in a tax haven country with a favorable tax treaty, and tax shelters (S. 2498). The objective of these efforts appears to be to bring a single comprehensive pension security measure to the Senate Floor.

Senate Labor Committee Package

As previously reported, the Senate Health, Education, Labor, and Pensions Committee, chaired by Senator Edward Kennedy, on sharply divided party line vote, adopted a controversial measure of pension security legislation (S. 1992). The Senate Labor Committee measure reflects several concerns raised by the Board that:

- Permit the continued use of employer stock matches and of company stock as an investment option, but not both
- Prohibit the required investment of plan assets in company stock
- Require a 30-day written notice in advance of any lock-down, which could not continue for an unreasonable period of time

The measure also:

- Allows plan sponsors to designate independent investment advisors for participants, in accordance with certain guidelines
- Requires pension benefit statements be issued on a quarterly basis
- Requires the plan fiduciary of an individual account plan having more than 100 participants to have to provide adequate insurance coverage for failure to comply with fiduciary duties. Liability for breach of fiduciary duty would be extended to other persons who participate in or conceal such breach
- Requires that insider stock transactions be disclosed promptly in electronic form
- Requires that a single employer plan which has an individual account plan covering more than 100 participants be governed by a board of trustees, equally divided between those representing the employer and participant interests. In the case of collectively bargained plans, the trustees representing employee interests would be determined by election in which all participants may participate.

Senate Finance Committee Proposal
On July 11, the Senate Finance Committee reported out its version of pension security legislation (S. 1971) on a broad bipartisan basis. The provisions that reflect Board concerns include:

- Diversification of defined contribution plan assets
- Providing information to assist participants
- Protection of workers during blackouts (A provision addressing this concern has already been enacted as part of the Sarbanes-Oxley Act, and as such may be dropped from the final pension security legislation)

The bill also:

- Requires the fiduciary's duty to provide material information
- Requires electronic disclosure of insider trading
- Requires independent investment advice be provided for participants
- Requires the clarification of the individuals right to sue a fiduciary under ERISA
- Requires the raising of the bonding level of fiduciaries
- Requires the Secretary of Treasury to complete regulations that ensure that participants are making informed decisions as to which form of benefit to elect

ELK HILLS COMPENSATION

CalSTRS continues to work with House Ways and Means Committee Chairman Bill Thomas and Senator Dianne Feinstein to pursue the necessary Congressional appropriation of the fifth $36 million installment of Elk Hills compensation, which is due for FY 2003.

As previously reported, a letter requesting the Elk Hills appropriation was sent from all 52 California House Members to the House Appropriators. The House Interior Appropriations Subcommittee, followed by the full House Appropriations Committee, and the full House of Representatives have approved the FY 2003 Interior Appropriations measure containing the full $36 million in funding for the payment for the fifth installment of Elk Hills compensation to CalSTRS.

In the Senate, Senate Interior Appropriations legislation reported out by the Interior Appropriations Subcommittee and then the full Appropriations Committee - and now on the Senate Floor for consideration – includes the $36 million in Elk Hills funding.

CalSTRS' Washington counsel continues to monitor developments on the Senate Floor to watch for any surprises. Once the Senate has completed action, the Interior Appropriations measure will go to a House-Senate Conference Committee to resolve the difference between the House and Senate Versions.

LEGISLATION TO ADDRESS "CORPORATE INVERSIONS"

There has been recent legislative activity in Congress to address "corporate inversions." In an "inversion", the U.S. parent company of the corporate group reincorporates offshore in a tax haven country, such as Bermuda, which has available to it the benefits of a tax treaty with the U.S. By reincorporating as a foreign corporation, the foreign subsidiaries are effectively moved offshore away from the U.S. taxing jurisdiction.

The Treasury Department has challenged the practice. In addition, the Senate Finance Committee has reported out S. 2119, which targets corporate inversions and which is intended to limit the federal income tax reasons for inversions. This anti-inversion legislation may be melded into the Senate pension legislation on the Senate Floor. In the House, Chairman of the House Ways and Means Committee, Bill Thomas has included inversion curbs in a broad international tax measure (H.R. 5095) that has been bogged down in controversy on other aspects of the bill.

SUMMARY OF FEDERAL LEGISLATION

The last attachment is a summary of all federal legislation that contains provisions of interest to CalSTRS or its members, and their current status in Congress.

Mr. Derman will provide a verbal update at the meeting.

MEMORANDUM FOR
THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

Washington Monthly Report

Investor Protection and Accounting Oversight Legislation

The landmark investor protection and accounting oversight legislation, known as the Sarbanes-Oxley Act of 2002, was passed by Congress on July 25 and signed into law by the President on July 30. Since that time, we have provided various briefing materials to STRS staff and worked with the staff to analyze the impact of the legislation. Attached to this month's report is a detailed analysis of the Sarbanes-Oxley measure prepared by the corporate department of our firm. A second attachment is an analysis prepared by our firm of new corporate governance rules for listed companies adopted by the New York Stock Exchange and Nasdaq.

The principal first step in the implementation by the Securities and Exchange Commission of the Sarbanes-Oxley Act has been with respect to the requirement that Chief Executive Officer and Chief Financial Officer of public companies certify the accuracy of their companies' financial reports. We have provided briefing materials to STRS staff on these developments.

The new five-member accounting oversight board adopted by the Sarbanes-Oxley Act, known as the Public Company Accounting Oversight Board, is now in the process of being created. The five Board members serve on a full-time basis for a five-year term, subject to reappointment for one additional term. Two of the Board's members may be members of the accounting profession.

Under the final legislation, Board members are to be chosen by the SEC, following consultation with the Secretary of the Treasury and the Chairman of the Federal Reserve Board of Governors. That process is actively underway, and reportedly well over 200 hundred nominations have been received from all quarters of groups involved in financial markets. Two key Senate leaders on the Sarbanes-Oxley legislation, Senate Banking Securities Subcommittee Chairman Chris Dodd (D-Conn.) and Sen. Jon Corzine (D-N.J.), are publicly promoting former Fed Chairman Paul Volcker to chair the new Board. Appointment of the initial members of the Board is required under the Act to be completed within 90 days after the July 30 enactment date, in order that the Board may begin operation with 270 days after enactment.

Pension Security Legislation

House Legislation

As previously reported, on April 11, the House of Representatives passed the first piece of legislation responding to the Enron debacle by adopting a pension security package, H.R. 3762 (the "Pension Security Act of 2002"). This legislation melded together competing versions of the legislation produced by the House Ways and Means Committee, chaired by Rep. Bill Thomas (R-Bakersfield), and the Education and Workforce Committee, chaired by Rep. John Boehner (R-Ohio).

The key features of the House pension security legislation, according to the official description, are as follows:

Investment Education and Benefit Statement:

- The bill requires the plan administrator of a self-directed defined contribution plan to provide an annual notice to plan participants and beneficiaries of the value of investments allocated to their individual account, including their rights to diversify any assets held in employer securities. Defined benefit plans would have to provide a benefit statement at least one every 3 years to be a participant.

- The notice will also include an explanation of the importance of a diversified investment portfolio including a risk of holding substantial portions of a portfolio in any one security, such as employer securities.

- The Secretary of Treasury will issue guidance and model notices that include the value of investments, the rights of employees to diversify any employer securities and an explanation of the importance of a diversified investment portfolio. Initial guidance will be no later than January 1, 2003. The Secretary may also issue interim model guidance.

- Notice may be electronic if reasonably accessible to the recipient.

Blackout Notices [1/]

Inapplicability of Relief from Fiduciary Liability During Suspension of Ability of Participants to Direct Investments

- The bill explains fiduciary duty during blackout period. It clarifies that fiduciaries are not liable for losses provided that fiduciaries satisfy the requirements of this title.

- Relevant considerations in determining the satisfaction of fiduciary duty are also added, such as the provision of the blackout notice, the fiduciary's consideration of the reasonableness of the period of suspension, and the fiduciary's actions solely in the interest of participants and beneficiaries.

Diversification:

- The bill ensures that all employee contributions to pension plans will be immediately diversifiable.

- The bill provides for a five-year transition rule for the allowable diversification of employer securities held in individual account plans as of the date of enactment.

- The bill provides for the option of a rolling three-year diversification of employer securities. In this case employer securities may be diversified three years after the calendar quarter in which they were contributed.

- The bill in general exempts individual account plans that do not hold employer securities that are readily tradable on an established securities market.

[1/] The House bill also includes a provision addressing the so-called "blackouts", usually done during changes in plan administrators, during which participant access to plan distributions is restricted. A provision addressing this issue already has been enacted as part of the Sarbanes-Oxley Act, and hence the "blackout' provision may be dropped from the final pension security legislation.

Investment Advice:

- The bill includes the text of H.R. 2269, the Retirement Security Advice Act, which provides increased availability of investment advisors to assist plan participants in making good decisions about their retirement assets.

- Employees will also be able to use pre-tax dollars to obtain their own investment advice.

Senate Legislation

Senate Majority Leader Tom Daschle (D-S.D.) is coordinating the melding competing versions of pension security legislation reported out by the Senate Health, Education, Labor, and Pensions (HELP) Committee (S. 1992) and the Senate Finance Committee (S. 1971), which has jurisdiction over the tax rules governing pension plans and shares jurisdiction over ERISA with the Senate Labor Committee. The aim is to bring a single comprehensive pension security measure to the Senate Floor, possibly as early as the third week of September, after the Senate completes action on the homeland security legislation.

As described below, the Senate HELP Committee bill contains several controversial amendments under ERISA (which would not apply to public plans such as STRS), including joint trusteeship of the retirement plan by management and labor and new claims for breach of fiduciary liability.

Senate Majority Leader Daschle and Senate Finance Chairman Baucus reportedly are considering adding to the pension security legislation a package of small business tax breaks intended to be part of an increase in the minimum wage as well as legislation already reported out of the Finance Committee addressing so-called corporate inversions (S. 2119) and tax shelters (S. 2498).

a. Senate Labor Committee package

As previously reported, the Senate Health, Education, Labor, and Pensions Committee, chaired by Sen. Edward Kennedy (D-Mass.), adopted a controversial version of pension security legislation (S. 1992) on a sharply divided party line vote.

The Senate Labor Committee measure would permit continued use of employer stock matches and of company stock as an investment option, but not both. Employer requirements that plan assets be invested in employer stock would be barred.

Plan sponsors could designate independent investment advisors for participants, in accordance with certain guidelines. Pension benefit statements would be required on a quarterly basis.

The plan sponsor and plan administrator would have a new fiduciary duty under ERISA to provide each participant who exercise control over assets in his or her account with "all material investment information regarding investment of such assets to the extent that such information is generally required to be disclosed by the plan sponsor to investors in connection with an investment under the applicable securities laws."

The plan fiduciary could be sued under ERISA for breach of fiduciary duty. The fiduciary of an individual account plan having more than 100 participants would have to provide adequate insurance coverage for failure to comply with fiduciary duties. Liability for breach of fiduciary duty would be extended to other persons who participate in or conceal such breach.

Thirty days written notice would have to be provided in advance of any "lock-down", which could not continue for an unreasonable period of time.

Insider stock transactions would have to be disclosed promptly in electronic form.

Finally, in a significant and likely controversial change to ERISA, the Senate Labor Committee proposal requires that a single employer plan which an individual account plan covering more than 100 participants must be governed by a board of trustees, half of whom shall represent employer interests and half shall represent participant interests. In the case of collectively-bargained plans, the trustees representing employee interests are to be determined by election in which all participants may participate.

b. <u>Senate Finance Committee proposal</u>

The Senate Finance Committee on July 11 reported out its version of pension security legislation (S. 1971) on a broad bipartisan basis. We have provided the legislative language and accompanying Committee Report to STRS staff for their review.

As described in the official Committee summary, the following are the key components of the Finance Committee pension legislation:

<u>Diversification of Defined Contribution Plan Assets</u>. A typical defined contribution pension plan may keep workers locked into company stock contributed by the employer indefinitely. Employee Stock Ownership Plans

(ESOPs), which by definition are highly concentrated in employer stock, are the only plans currently subject to diversification requirements, and they are only required to allow workers to begin diversifying their holdings once they reach age 55 and have 10 years of participation in the plan. The bill generally provides that publicly held companies must allow workers to divest themselves of company stock once they have completed 3 years of service (with a 3 year phase-in for stock contributed in previous years). Only free-standing ESOPs are exempt from the requirement.

Protection of Workers during Blackouts. [2/]

Providing Information to Assist Participants. Under current law, plan administrators are generally not required to provide benefit statements to workers except when the workers themselves request a statement, and then no more than once each year. There is also no requirement for pension investment guidelines and information to be provided. The bill requires quarterly benefit statements for defined contribution plans that allow workers to direct their own investments; annual statements for plans that do not allow worker investment direction; and once every 3 years to workers in defined benefit plans. The bill also requires all workers to receive annual investment guidelines and information that would, at a minimum, include: information on the benefits of diversification of investments; the differences in risk and returns of various forms of investments; and information on investment allocations based on age and years to retirement.

Fiduciary Duty to Provide Material Information. The bill requires sponsors of defined contribution plans under a new ERISA provision to ensure that all material information the employer is required to disclose to investors under the securities laws also be provided to workers concerning investments in company stock in the worker's account. There is no comparable requirement in current law.

Electronic Disclosure of Insider Trading. The bill requires that companies sponsoring plans that allow workers to invest in employer stock disclose to plan participants any sale of stock by an officer, director, or affiliate or the employer that is required to be disclosed to the SEC. The information must be posted on the plan's website in a reasonably practicable timeframe after disclosure to the SEC.

[2/] The Senate Finance Committee bill also includes a provision addressing so-called "blackouts" during which participant access to plan distributions is restricted. A provision addressing this issue already has been enacted as part of the Sarbanes-Oxley legislation, as hence the Finance Committee version may be dropped from the final Senate pension security legislation.

Independent Investment Advice. Questions exist under current law concerning the extent of an employer's liability under ERISA for investment advice given to participants, and these questions have had a chilling effect on the willingness of many companies to make investment advice available through their pension plan to their workers. The bill establishes a checklist that, once successfully completed by the employer, relieves him/her of liability for any losses that result from the investment advice given. The items that must be verified by the employer include: that the investment advisor is qualified; that the advisor accepts full fiduciary liability for any advice given; that the advisor is independent (does not have financial conflicts with respect to the plan); that the advisor will take into account employer stock held by the worker when providing its advice; and that the advisor has the necessary insurance coverage for any claim by a participant or beneficiary.

Clarification of Access to Remedies. Recent court decisions have raised uncertainty about the extent to which plan participants may sue a fiduciary on their own behalf to recover losses to their pension plan accounts. The bill clarifies the individual's right to sue under ERISA.

Bonding of Fiduciaries. Under current law, fiduciaries are required under ERISA to post a bond equal to 10% of the funds they handle, but not to exceed $500,000. Fiduciary bonds are designed to cover losses stemming from fraud or dishonesty by plan officials, and the maximum bonding cap has not been raised since the mid-1970s. The bill increases the bond cap to $1 million for plans containing employer stock.

Optional Forms of Benefit Calculations. Under defined benefit plans, participants generally may choose among a variety of forms of benefits. Treasury is working on regulations specifying the types of information that must be made available to workers before they must make these decisions, but the regulations did not get completed in last year's business plan and it is uncertain when they'll be issued. In the meantime, plan participants are faced with making decisions about benefit options, sometimes without fully understanding the financial consequences of these decisions. This can be particularly true in cases where one or more of the options effectively eliminates a type of benefit, such as an early retirement incentive, and that fact is not made clear to the participant. The bill requires the Secretary of Treasury to complete its regulations within 30 days of the bill's enactment, and expresses the Committee's expectation that the regulations will ensure that participants are making informed decisions as to which form of benefit to elect, including early retirement benefits that are incorporated into the calculations.

Executive Compensation Provisions

The Senate Finance legislation also contains four proposals to ensure appropriate taxation of executive compensation, including certain bonuses, loans, and deferred compensation arrangements.

Enforce Deferred Compensation Rules. Since 1978, the Treasury Department has been limited in its ability to enforce laws that determine whether executive deferred compensation arrangements should be taxed currently or deferred until the funds are distributed. The legislation would remove a 1978 moratorium on new regulations and permit Treasury to better define deferred compensation arrangements that merit deferral of taxation and those that should be taxed currently.

Prohibit Deferral on Compensation Parked in Offshore Trusts. In order for a trust to qualify as nontaxable deferred compensation, the monies in the trust must be subject to the claims of general creditors. Placement of funds in offshore trusts can be used to thwart attempts by U.S. bankruptcy courts to access these compensation arrangements. The legislation generally provides that funds in an offshore trust will be deemed not to be subject to the claims of creditors, and generally the funds will be taxed. An exception would be provided for situations where the employee for whom the trust is established provides personal services in the foreign jurisdiction.

Increase Withholdings on Bonuses. Under current law, employers may elect to withhold income tax on supplemental wages at a flat 27% rate. Most executives and employees receiving million dollar bonuses will ultimately be taxed at the rate of 38.6%. The proposal increases the withholding rate to the highest marginal tax rate (currently 38.6%) on supplemental pay of over $1 million.

Clarify Definition and Tax Treatment of Executive Loans. Whether a payment to an executive is a loan or compensation is a facts-and-circumstances test. The legislation would clarify that a payment would be considered as compensation rather than loan unless the arrangement met minimum standards (written debt instrument, established repayment periods, and adequate security). In addition, loans above $1 million would be required to have an interest rate equal to 3 percentage points higher than the applicable government published rate.

Miscellaneous Provisions

Faster Right to Divest For Those Age 55. The bill gives individuals the right to divest company stock contributed to a defined contribution account by the employer after three years of service. A transition rule permits companies to require the diversification of previously contributed stock over a three-year period. The amendment incorporated would permit immediate divestiture for employees who are nearing retirement (age 55 or older).

Teachers Benefit Plans. This provision addresses two issues: retirement plans for teachers that provide retention bonuses, and plans that provide early retirement incentives. Retention bonuses are caught in a dilemma which requires them to be valued for tax purposes when earned, even though it is impossible to calculate their value at that time because the retirement date is unknown. In the case of early retirement bonuses, most school districts pay teachers in different amounts based on age. Age is used because it is the basis for receiving different amounts from the state retirement system or social security. One appeals court has determined such a system violates the Age Discrimination in Employment Act (ADEA) even though the program is voluntary. This provision corrects both of these problems.

Exclude Broad-Based Stock Options from Wages. This provision provides for no taxation of the exercise of an incentive stock option (ISO) or under an employee stock purchase plan (ESPP), consistent with a recent Treasury announcement of an indefinite moratorium on requiring withholding of FICA and FUTA on ISOs and ESPPs.

Modify Holding Period Requirements for Stock Options for Executive Branch Appointees. This provision eliminates the holding period requirement for capital gains treatment with respect to ISOs and ESPPs for executive branch appointees and nominees who are required to divest these holdings. Current law requires them to hold the options for either two years after the granting of the option or one year from the exercise of the option to receive this treatment. The Office of Government Ethics has urged this change.

2001 Interest Rate Adjustment for Private Sector Defined Benefit Plans. The economic stimulus bill provided a short-term alternative to the traditional interest rate used for computation of contributions under private sector defined benefit plans after Treasury suspended issuance of certain 30-year debt instruments. The modification affected contributions related to 2002 and 2003. This provision would provide a more limited alternative computation for contributions related to 2001 (which are generally being made in 2002).

Automatic Rollovers of Certain Mandatory Distributions. This provision modifies a provision included in the pension section of EGTRRA to specify that amounts transferred from a qualified retirement plan to an IRA in an automatic rollover are no longer plan assets for ERISA purposes.

Chief Executive Officer Must Sign Federal Income Tax Return. This provision requires that the chief executive officer of a corporation must sign the federal income tax returns under penalties of perjury. Current law permits a signature by the president, vice-president, treasurer, assistant treasurer, chief accounting officer, or other officer duly authorized.

Elk Hills Compensation

We are continuing our year-long effort to pursue the necessary Congressional appropriation of the fifth $36 million installment of Elk Hills compensation due for FY 2003, working with our House champion, House Ways and Means Committee Chairman Bill Thomas (R-Bakersfield), and our Senate champion, Sen. Dianne Feinstein (D-Ca.).

As previously reported, the entire 52 Member California House delegation sent a letter to the House appropriators in strong support of the appropriation for the fifth installment of Elk Hills compensation.

We are pleased to report that the House Interior Appropriations Subcommittee, followed by the full House Appropriations Committee, and the full House of Representatives have approved the FY 2003 Interior Appropriations measure containing the full $36 million in funding for payment of the fifth installment of Elk Hills compensation to STRS.

On the Senate side, we worked with Sen. Dianne Feinstein (D-Ca.) seeking a comparable provision in the Senate's version of the Interior Appropriations legislation. We are pleased to report that the Senate Interior Appropriations legislation reported out by the Interior Appropriations Subcommittee and then the full Appropriations Committee – and now on the Senate Floor for consideration – includes the $36 million in Elk Hills funding.

We are continuing to monitor developments on the Senate Floor to watch for any surprises. Once the Senate has completed action, the Interior Appropriations measure will go to a House-Senate Conference Committee to resolve the differences between the House and the Senate versions.

Legislation to Address "Corporate Inversions"

We understand that there is interest among STRS Board members with respect to the recent trend of "corporate inversions". There has been a spate of recent legislative activity in Congress addressing so-called "corporate inversions". In an "inversion", the U.S. parent company of the corporate group reincorporates offshore in a tax haven country, such as Bermuda, which has available to it the benefits of a tax treaty with the U.S.

The supposed genesis of these inversions was the difficulty the "inverting" U.S. company asserted that it faced in head-to-head competition in foreign markets with foreign companies subject to a territorial system of taxation which taxes only income earned in the home country. By comparison, the U.S. taxes its companies on income earned abroad, generally upon repatriation to the U.S. In the inversion transaction, the U.S. parent reincorporates as a foreign corporation, and the foreign subsidiaries are effectively moved offshore away from the net of the U.S. taxing jurisdiction. In addition, the Treasury Department has challenged the practice as also permitting U.S. earnings to be stripped out of the U.S. taxing jurisdiction by way of deductible interest payments by the U.S. subsidiary on intercompany debt to its newly-reincorporated foreign parent.

The Senate Finance Committee has reported out S. 2119 targeted at corporate inversions which is intended to curb the federal income tax reasons for inversions. As noted above, this anti-inversion legislation may be folded into the Senate pension legislation on the Senate Floor. On the House side, House Ways and Means Chairman Thomas has included inversion curbs in a broad international tax measure (H.R. 5095) that has been bogged down in controversy on other aspects of the bill.

Inversions also have come under attack on the Congressional appropriations front. Congressional Democrats have sought to bar inverted companies from receiving contracts with the Federal government. Thus far, they have succeeded in including in the House and Senate versions of the Homeland Security legislation a bar against contracts between inverted companies and the new Department of Homeland Security to be created by the legislation.

John S. Stanton

Washington, D.C.
September 9, 2002

Attachments

SEC update

Major Securities Reform Legislation Enacted

July 31, 2002

On July 25, Congress overwhelmingly enacted the Sarbanes-Oxley Act of 2002, and President Bush signed it into law on July 30. This landmark legislation, which is 130 pages long, is the most wide-ranging and far-reaching securities reform legislation enacted since the mid-1930s. The Act will have a dramatic impact not only on the companies affected by it, but also on their insiders, auditors and lawyers. It applies to all public companies (domestic or foreign) that have registered or file reports under the Securities Exchange Act of 1934, as well as companies that have a registration statement pending under the Securities Act of 1933 that has not been withdrawn. The Act's provisions become effective at various times, but companies would be well-advised to give immediate attention to those provisions (particularly the officer certification requirements discussed on pages 6-8) that became effective upon enactment.

Although the Act is now law, many of its provisions will be affected by subsequent developments. Some provisions dealing with corporate governance matters may eventually be overtaken by efforts currently underway by the stock exchanges and Nasdaq to impose more stringent requirements. Others require SEC rulemaking in order for full implementation. And still others may lead to further legislation or rulemaking because of the many studies mandated by the Act that could suggest a need for additional changes.

Our report of the Act begins with a list of its major features, continues with a description and analysis of these features, and concludes with a list of the effective dates of the Act's many provisions.

MAJOR FEATURES

The Act is intended to address perceived defects in the securities laws that contributed to a series of corporate scandals, many of which involved allegations of improper accounting and auditing practices, and wrongdoing by insiders. The provisions of the Act are directed primarily at public companies and their insiders and auditors, and employ a wide variety of measures to raise the level of compliance by these parties. These measures seek generally to (i) upgrade company disclosures, (ii) strengthen corporate governance requirements, (iii) expand insider accountability, (iv) heighten auditor independence, (v) increase auditor oversight, and (vi) broaden sanctions for wrongdoing. Key provisions of the Act intended to implement these purposes are summarized as follows:

Upgrade Company Disclosures

- Real time disclosure required of material changes in financial condition or operations of company
- Disclosure required of all material off-balance sheet transactions
- Use of pro forma financial information restricted
- Disclosure required of all material correcting adjustments by company's auditor
- Disclosure required of annual assessments of internal controls by management and independent auditor
- Expanded SEC review required of periodic disclosures by public companies, with each company's disclosures to be reviewed at least once every three years

Strengthen Corporate Governance

- Audit committee required that must be composed solely of independent, outside directors, and must have sole responsibility for hiring and overseeing company's auditor
- Minimum standards of professional conduct required to be issued by SEC for counsel that practice before SEC
- Job protection mandated for employee whistleblowers

Expand Insider Accountability

- CEO and CFO certifications required for (i) each annual and quarterly report, and (ii) each periodic report containing financial information
- Incentive compensation and trading profits of CEO and CFO required to be forfeited where compensation and profits related to financial reports that subsequently were restated because of misconduct
- Deadline for insiders to report transactions involving their company's equity securities accelerated to two business days after occurrence of transaction
- New loans by company to insiders prohibited
- Insider trades restricted during pension fund blackout periods
- Disclosure required of existence or nonexistence of code of ethics for senior financial officers

Heighten Auditor Independence

- Non-audit services restricted
- Rotation of audit partner (but not entire firm) required at least every five years
- Auditor conflicts of interest limited by requiring one-year cooling-off period before member of audit staff can be hired by client for high level executive position
- Improper influence by corporate personnel on the conduct of audit prohibited

Increase Auditor Oversight

- Independent auditor oversight board created to regulate (with SEC oversight) public company auditors and audits
- Registration with oversight board required of accounting firms that audit public companies
- Adoption by oversight board of auditing, quality control, ethics and independence standards required
- Authority granted to board to inspect and discipline registered accounting firms

Broaden Sanctions for Wrongdoing

- Criminal sanctions enhanced by (i) increasing penalties for pre-existing crimes, (ii) creating new criminal offenses, (iii) lengthening federal sentencing guidelines, and (iv) expanding SEC enforcement powers
- Civil sanctions enhanced by (i) extending statute of limitations for securities fraud, (ii) vesting SEC with power to bar directors and officers from public company service, and (iii) prohibiting discharge in bankruptcy proceedings of debts relating to securities fraud

Miscellaneous Matters Also Warranting Attention

- Analyst Conflicts of Interest
- Mandated Studies
- SEC Resources and Authority

DESCRIPTION AND ANALYSIS

A. Upgrade Company Disclosures

Real Time Disclosure

Section 409 of the Act requires companies reporting under Sections 13 or 15(d) of the Exchange Act to disclose publicly "on a rapid and current basis" such additional information concerning material changes in their financial condition or operations as may be prescribed by an SEC rule. The SEC already has taken action to implement this requirement by proposing in June 2002 to (i) expand the items reportable on Form 8-K from six to 19, and (ii) accelerate the deadline for reporting on that form to two business days after occurrence of the event subject to reporting. Accordingly, all that remains for the SEC to implement this requirement is the adoption of final changes to its proposal based on the public comments.

Disclosure of Off-Balance Sheet Transactions and Pro Forma Figures, and Inclusion of Material Auditor Adjustments in Financial Reports

In an effort to prevent future problems of the type involved in the Enron situation, Section 401 of the Act directs the SEC to adopt final rules within 180 days requiring disclosure of all material off-balance sheet transactions, arrangements, obligations and relationships, including those with unconsolidated entities. Similar rulemaking to restrict the use of pro forma financial information also is mandated. Specifically, the rules are to require that pro forma information included in any SEC report, or in any other public disclosure by the company (such as a press release), must not be materially misleading and must be reconciled under GAAP with the company's financial condition and results of operations.

Section 401 contains other requirements as well. Financial statements included in reports filed with the SEC must reflect all material correcting adjustments that are identified by the company's auditor as being in accordance with GAAP and SEC requirements. And Section 401 directs the SEC to complete a study of off-balance sheet transactions and the use of special purpose entities, and to make recommendations regarding the future treatment of such transactions and entities.

Disclosure of Management's Assessment of Internal Controls

Section 404 of the Act requires the SEC to adopt rules requiring a reporting company to include in its annual report under the Exchange Act an "internal control report." This report is to (i) state management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and (ii) assess, as of the end of the company's most recent fiscal year, the effectiveness of the company's internal control structure and its financial reporting procedures. In addition, the company's auditor is required to attest to, and report on, management's assessment.

Expanded SEC Review of Disclosure Documents

To improve the quality of disclosures made by reporting companies, Section 408 of the Act requires that the SEC review "on a regular and systematic basis" the disclosures made by such companies. Factors such as market capitalization, volatility, and material financial restatements are to be taken into account by the SEC in determining the frequency of review, which is to occur at least once every three years.

B. Strengthen Corporate Governance

Audit Committee Requirements

Section 301 of the Act sets forth various requirements for a public company's audit committee designed to preserve the committee's independence and provide it with sufficient power and funding to ensure the integrity of the audit process. To prevent companies from avoiding these requirements, the Act directs the SEC to adopt rules requiring the national securities exchanges and Nasdaq to prohibit the listing of any security of a company that does not meet the audit committee requirements. For those companies that do not have an audit committee, the Act provides in Section 2(3) that the full board of directors should be deemed to be the committee.

The requirements for the audit committee cover five areas:

- Responsibilities. The committee is to be "directly responsible for the appointment, compensation, and oversight" of the auditors, and the auditors must report directly to it.
- Independence. Each committee member must be a member of the board of directors who is considered "independent." To be deemed independent, the member must not (i) accept any compensation from the company other than that for serving as a board member, or (ii) be an affiliate of the company or its subsidiaries. The SEC, in appropriate circumstances, may exempt a particular relationship from the independence requirement.
- Complaints. The committee must establish procedures for processing (i) complaints regarding accounting, internal control, or auditing matters, and (ii) confidential, anonymous submissions by employees of concerns regarding questionable accounting or auditing matters.
- Engaging Advisors. The committee must have the authority to engage independent counsel and other advisors, to the extent the committee considers necessary to carry out its duties.
- Funding. The company must provide appropriate funding (as determined by the committee, not the board) for the payment of compensation to the auditors and to others employed as counsel or advisors to the committee.

In addition to the foregoing, Section 407 of the Act requires the SEC to issue rules requiring the company to disclose whether the committee contains at least one member who is a "financial expert," and if not, why not. The SEC is required by Section 407 to define the term "financial expert" in its rules, but Congress has directed the Commission to consider in that regard various criteria that appear weighted in the direction of persons (such as public accountants, auditors, CFOs and comptrollers) who can readily be presumed through their education and experience to have the requisite expertise.

Section 301 grants audit committees significantly greater authority and responsibility than has been customary. Congress clearly intended that the committee's relationship with the outside auditors be a direct one that is unfiltered by management, and that the committee establish mechanisms for the free flow of information from whistleblowers and others with accounting concerns. To meet these added responsibilities, the committee may find it necessary in many instances to lean heavily on counsel and other advisors for assistance.

The determination of what procedures the committee should adopt will depend on the particular circumstances. The committee, however, may wish to consider (i) revisiting its charter to assure it accurately reflects the committee's duties and responsibilities, (ii) formalizing in writing procedures for dealing with disagreements between management and the auditors regarding financial reporting, (iii) adopting measures to ensure the continued independence of all committee members, and (iv) establishing procedures for processing complaints and confidential submissions regarding accounting concerns.

Standards of Professional Conduct for SEC Counsel and Job Protection for Employee Whistleblowers

One of the most controversial provisions of the Act is Section 307, which directs the SEC to issue rules within 180 days after enactment setting forth minimum standards of professional conduct for attorneys who represent companies before the SEC. The standards are to include a rule requiring the attorney to report to the CEO or chief legal counsel of the company "evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof." If the CEO or chief legal counsel does not respond appropriately, the attorney is to report the evidence to either the audit committee, a committee composed solely of nonemployee directors of the company, or the full board. SEC lawyers complain that Section 307 imposes a higher duty on them than the Model Rules of Professional Conduct by requiring them to report evidence without the ability to weigh its probity or credibility. They hope to persuade the SEC to address this concern when it adopts the rules in question.

Section 806 of the Act contains another "whistleblower" provision, but this one is not clouded by the controversy surrounding the one described above. Section 806 simply provides protection against employment termination or other retaliatory action for any employee, contractor, subcontractor or agent of a public company who (i) provides evidence regarding conduct that the employee reasonably believes violates federal securities or antifraud laws, or (ii) testifies or participates in, or files, a securities or antifraud proceeding. Relief can include reinstatement, back pay or special damages.

C. Expand Insider Accountability

CEO and CFO Certification of Company Reports

To assure that the CEO and CFO are actively involved in the process of preparing the company's annual and quarterly reports, Section 302 of the Act requires the SEC to adopt rules within 30 days of enactment requiring the CEO and CFO to certify in each such report filed with the SEC that:

- The signing officer has reviewed the report;
- Based on the officer's knowledge, the report does not contain any material misstatements or omit any material facts;
- Based on the officer's knowledge, the financial information in the report fairly presents in all material respects the company's results of operations and financial condition;
- The signing officers (i) are responsible for establishing and maintaining the company's internal controls, (ii) have designed the controls to ensure that material information regarding the company and its subsidiaries is made known to the officers, particularly during the period in which the company's periodic report is being prepared, (iii) have evaluated the effectiveness of the internal controls within the preceding 90 days, and (iv) have presented in the report their conclusions about the effectiveness of the controls based on their evaluation;

- The signing officers have disclosed to the auditors and the audit committee all significant deficiencies and material weaknesses in the company's internal controls, as well as any fraud, "whether or not material," involving management or other employees who have a significant role in the company's internal controls; and
- The signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions taken with regard to significant deficiencies and material weaknesses.

The foregoing certification requirement is distinct from other certification requirements that may apply to the CEO and CFO. It is significantly broader in scope than that required by the SEC's one-time order (No. 4-460) issued on June 27 to nearly 1,000 large companies. The certification required by that order is not affected by the Act, as it is limited only to the companies designated by the SEC, and relates only to the company's annual report for its last fiscal year and any subsequent quarterly reports filed by the company prior to the filing of the certification. Of greater concern is the apparent conflict between the certification standard of Section 302 and that of Section 906 of the Act, which is a criminal provision that carries with it severe penalties for noncompliance (fine of up to $1 million and imprisonment up to 10 years, with willful violations meriting a fine up to $5 million and imprisonment up to 20 years). Section 906 states that each periodic report containing financial statements filed by a company with the SEC pursuant to Section 13(a) or 15(d) of the Exchange Act "shall be accompanied by a written statement" certifying that the report "fully complies" with the requirements of Section 13(a) or 15(d) and that the information contained in the report "fairly presents, in all material respects, the financial condition and results of operations" of the company. Unlike the Section 302 certification, the Section 906 certification is not by its terms restricted in scope by the certifying officer's knowledge, nor is it subject to any materiality qualifier. Consequently, anything less than a fully compliant report will, in theory, expose the signing officer to potential criminal sanctions.

The differences between the Section 302 and Section 906 certifications are so striking as to make it appear that two separate certifications are necessary under the Act. This is an undesirable result, for which relief or clarification of some sort is promptly needed, due to the fact that Section 906 apparently became effective upon enactment and therefore applies to the next periodic report filed by every public company. (Note, however, Senator Enzi's belief, expressed in the Congressional Record of July 25, that "it was the intent of the conferees that the penalties under section 906 should not become effective until the rulemaking process [for Section 302] is finalized.") The SEC has pending a certification proposal that can be adapted to meet the requirements of Section 302 and could be used as a vehicle for providing guidance on Section 906. But a high-level member of the SEC staff informally has indicated that the staff views the Section 906 certification as being within the province of the Department of Justice because Section 906 is a criminal provision. Consequently, the staff has been reluctant to furnish guidance regarding it, and may decide that it should not do so.

A host of questions are being raised about the Section 906 certification requirement, ranging from the wording of the certification, the manner in which it is filed, and the reports it must cover. For example, there is a controversy whether Form 8-K reports, including those that contain financial statements, are "periodic reports" subject to the requirement. A question also exists as to whether the requirement that a Section 906 certification "accompany" the report to which it relates can be satisfied by simply characterizing the certification as "correspondence" when the report is filed on EDGAR, rather than formally filing it as an exhibit to the report. Another issue is whether it is possible to include in the certification a "knowledge" qualifier of the type permitted by a Section 302 certification, on the theory that the criminal penalties for violation of Section 906 apply only if an insider certifies a report that the insider knows does not comport with all applicable requirements. Similarly, there is a question whether a "materiality" qualifier is permissible.

Until more is known about the Section 906 certification requirement, CEOs and CFOs should assume that they will have to provide both a Section 302 certification and a separate Section 906 certification. Accordingly, they should begin immediately to take the steps necessary to provide a high degree of assurance that providing the more encompassing Section 906 certification will be a relatively low risk act. These steps may include (i) a critical examination of the company's internal controls and its processes for preparing periodic reports under the Exchange Act, (ii) the establishment of procedures for identifying internal control weaknesses and for notifying the auditors of any such weaknesses, (iii) a searching review of the draft of the next periodic report scheduled to be filed with the SEC, and (iv) an inquiry as to available D&O insurance for CEO and CFO certifications.

Forfeiture of Incentive Compensation and Trading Profits by CEO and CFO After Restatement

To prevent CEOs and CFOs from profiting from financial results that later are restated because of misconduct, Section 304 of the Act provides that the CEO and CFO of any company having to make such a restatement must reimburse the company for any bonuses or other incentive compensation, as well as any trading profits, derived during the 12-month period following the first public issuance or filing of the financial results. It is important to note that the term "misconduct" is not defined, and is not limited to misconduct by the officer who is required to make reimbursement. Because of the harsh results that could flow from this provision, the SEC is authorized to grant exemptions from it in appropriate circumstances.

Accelerated Insider Reporting

Section 403 of the Act amended Section 16(a) of the Exchange Act to shorten the deadline by which insiders (i.e., officers, directors and 10% stockholders) of public companies must report changes in their beneficial ownership of equity securities of the company. Currently, insiders generally are required to report changes in beneficial ownership on Form 4, within ten days after the end of the month in which the change occurs, but are allowed to report some types of changes (e.g., gifts and most option grants) on Form 5, within 45 days after the end of the fiscal year. Section 403 has dramatically accelerated these reporting deadlines by requiring insiders to report all changes in beneficial ownership within two business days after the transaction, although it authorizes the Commission to adopt rules permitting later reporting where two-day reporting is not feasible.

The new reporting deadlines become effective 30 days after enactment. Although they would appear to have rendered unnecessary the SEC's recent proposal to require insider transactions to be reported on Form 8-K by the insider's company within two business days after occurrence, the SEC staff may not necessarily agree. We think it is possible (perhaps even probable) that, rather than withdraw the proposal, the staff will simply modify it to allow the Section 16(a) reports to satisfy the 8-K disclosure requirement where the reports are filed as exhibits to the 8-K.

Separately, Section 403 provides that, no later than one year after enactment, insiders will have to file their Section 16 reports with the SEC electronically. In addition, the Act states that both the SEC and the insider's company will have to publish the electronically filed reports on the Internet by the end of the next business day after filing, although the company will not have to do so if it does not have a website.

It is unclear whether Section 403 has the effect of nullifying, without any rulemaking by the SEC, the current deadlines for filing Forms 4 and Forms 5, as well as the exemptions from the reporting requirements applicable to certain transactions (e.g., routine acquisitions under 401(k) plans). We anticipate that the SEC will take a position on this issue soon, and believe it is likely that the position will be that transactions currently reportable on Form 4 will be reportable within two business days, while transactions currently reportable on Form 5 will continue to be reportable within 45 days after the end of the company's fiscal year. We also think it is likely that the SEC will allow insiders to continue to rely on all currently available reporting exemptions.

Because the two-day reporting deadline will become mandatory soon for many types of transactions, companies that assist their insiders in complying with the reporting requirements need to act promptly to develop processes for obtaining information about insider transactions in time to prepare and file Forms 4 for their insiders by the deadline. Because most insiders file their Forms 4 in paper format, the reports generally will need to be completed within one business day, to allow time to overnight them to the SEC for arrival by the deadline. Companies that do not currently require insiders to clear all of their transactions with the company in advance should consider revising their insider trading policies to do so.

Prohibition of Loans to Insiders

To limit self-dealing, Section 402 of the Act prohibits public companies (other than investment companies) from making personal loans or extending credit, either directly or through a subsidiary, to executive officers and directors. The prohibition, which became effective immediately upon enactment, is subject to a few exceptions. Loans or credit extensions that were in existence at the time of enactment are excluded if they are not materially modified or renewed. Certain types of consumer loans made by companies engaged in the business of providing consumer credit also are excluded if the loans are made in the ordinary course of business on market terms, and are of a type generally made available by the company to the public. Loans that are permitted under this exclusion include home improvement and manufactured home loans, consumer credit loans, and margin loans by registered broker-dealers. Finally, loans by U. S. banks and thrifts are not subject to the prohibition where the lender is insured by the FDIC and the loans are subject to the insider lending restrictions of the Federal Reserve Act.

Restricting Insider Trades During Pension Fund Blackout Periods

In reaction to the widely-criticized sales of stock by Enron insiders during a period that rank-and-file members of Enron's employee benefit plans were forbidden to trade such stock, Section 306 of the Act prohibits directors and executive officers of public companies from acquiring or disposing of, during a pension fund blackout period, any equity security of the company that was acquired by the person in connection with his or her service or employment as a director or executive officer. Section 306 defines the term "blackout period" to mean a period of more than three consecutive business days during which the ability of 50% or more of the participants in the company's 401(k) and other ERISA individual account plans to trade company stock is suspended. The prohibition, which will become effective 180 days after enactment, does not extend to securities acquired outside the director or officer relationship (such as those acquired in the open market), nor does it apply during a blackout period incorporated into the plan pursuant to an express investment restriction that is disclosed to employees in a timely manner. Generally, at least 30-days advance notice of a blackout period must be given to plan participants and beneficiaries. The SEC, after consultation with the Department of Labor, is to adopt rules that clarify the application of the Section 306 trading prohibition and prevent evasion of it.

The remedy for trading in violation of the prohibition is similar to the remedy provided by Section 16(b) of the Exchange Act (i.e., an action by the company or any security holder acting on its behalf to recover for the company any profits realized by the director or executive officer as a result of trading in violation of the prohibition). The problem with the remedy is that it does not track Section 16(b) sufficiently to permit a determination of the extent to which profit may have been realized by an insider. Under Section 16(b), there must be both a purchase and a sale before any profit is realized, but Section 306 apparently would apply if there were only a single transfer, even for no value. It remains to be seen whether this remedy is workable, particularly in situations where there was no opposite-way transaction in close proximity to a transaction effected during a blackout period.

Mandating Disclosure Regarding Code of Ethics for Senior Financial Officers

Reflecting a concern that the practices of some CFOs and other high ranking financial officers are not always ethical, Section 406 of the Act requires public companies to disclose in their periodic reports whether they have established a code of ethics for their senior financial officers (i.e., the CFO, and the comptroller or chief accounting officer), and if not, why not. This requirement, which is to be implemented by an SEC rule adopted within 180 days of enactment, also would compel disclosure of any waivers of, or changes in, the code of ethics. The code is to consist of standards reasonably necessary to promote (i) honest and ethical conduct, (ii) "full, fair, timely and understandable" disclosure in the company's periodic reports, and (iii) compliance with applicable governmental rules and regulations.

D. Heighten Auditor Independence

Restricting Audit Services

To prevent audit firms from appearing to be beholden to the public companies that employ them to conduct audits, Section 201 of the Act will prohibit the firms, beginning 180 days after the date the Public Company Accounting Oversight Board (discussed later in this Update) commences operations, from rendering the following services to a public company client contemporaneously with the audit:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;

- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resources;
- Broker or dealer, investment adviser, or investment banking services;
- Legal services and expert services unrelated to the audit; and
- Any other services that the Public Company Accounting Oversight Board determines, by regulation, is impermissible.

An auditing firm may render tax and other non-audit services not included in the above list to an audit client only if the client's audit committee provides advance approval of the services. Section 202 of the Act indicates that such approval would have to be disclosed in the client's periodic reports under the Exchange Act.

It is unlikely that the limitation on non-audit services will present a major hardship for auditing firms. The current SEC rules on auditor independence already prohibit an auditor from rendering essentially the same non-audit services, although the differences between the above limitation and the SEC's rules may have to be reconciled in future SEC rulemaking.

Requiring Audit Partner Rotation at Least Every Five Years

Section 203 of the Act requires the lead audit partner of a public company's auditing firm to rotate out of the audit assignment after five years, in order for the firm to continue to be eligible to audit the client. The rotation requirement, which will not become effective until auditing firms are able to register with the Public Company Accounting Oversight Board, is intended to deal with the concern that an auditor's independence may be compromised over time by extensive contact with the client and its personnel. Section 207 of the Act directs the Comptroller General to conduct a study of the potential effects of requiring mandatory rotation of auditing firms, and to submit a report within one year.

Limiting Auditor Conflicts of Interest

Again reflecting some of the lessons learned in Enron and other situations, Section 206 of the Act seeks to limit potential conflicts of interest by making it unlawful for an accounting firm to perform audit services for a public company if the CEO, CFO, controller, chief accounting officer, or similar officer of the company was employed by the firm and participated in the audit of the company during the prior year. The "cooling off" period mandated by Section 206 may have a limited impact, since many companies already had concluded that it would be inadvisable to open themselves to potential criticism of the type leveled in Enron and other situations by hiring former audit personnel for high level executive positions.

Prohibiting Improper Influence on the Conduct of Audits

Section 303 of the Act deals with the problem of management personnel seeking to improperly influence the outcome of an audit by making it unlawful for any officer or director, or any other person operating under the direction of an officer or director, "to take any action to fraudulently influence, coerce, manipulate, or mislead" any auditor of the company "for the purpose of rendering [the company's] financial statements materially misleading." Section 303 directs the SEC to adopt rules to implement this prohibition within 270 days after enactment.

E. Increase Auditor Oversight

Creation of Independent Auditor Oversight Board

The centerpiece of the Act, from the standpoint of auditing reform, is Section 101, which authorizes the creation of the Public Company Accounting Oversight Board. The Board will oversee the audits of public companies, and will consist of five members appointed by the SEC, two of whom may be members of the accounting profession. Board members will serve on a full-time basis for five-year terms, and may be reappointed only once. Appointment of the initial Board members is to occur within 90 days after enactment, and the Board is to organize itself so that it can begin operations within 270 days after enactment. Instead of being an agency of the federal government, the Board will be a self-regulatory organization, overseen by the SEC in a manner similar to its oversight of the national stock exchanges and the NASD. Funding for the Board will come primarily from fees collected annually from public companies on the basis of their relative market capitalizations.

Board Registration of Public Company Auditing Firms

The principal duty of the board at the outset will be to register public accounting firms that prepare audit reports for issuers. Section 102 of the Act provides that, beginning 180 days after the Board begins operating, only public accounting firms that are registered with it, and agree to Board oversight, will be permitted to participate in the preparation of audit reports for public companies. Registration will involve the submission of an initial application and subsequent annual reports, as well as the payment of fees to cover the costs of processing and reviewing the application and reports. Both domestic and foreign public accounting firms will be subject to the registration requirement if they perform audit services for public reporting companies in the United States.

Standard Setting by the Board

Although the Board will not have the power to establish accounting principles, it will have the authority to establish standards relating to the auditing process. Section 103 of the Act states that the Board will have the responsibility for establishing standards for auditing, quality control, ethics, and independence for registered public accounting firms. In adopting these standards, the Board will be permitted simply to carry over existing standards published by organizations such as the AICPA. All standards adopted by the Board will be subject to SEC approval. The auditing standards will be required by Section 103 to include rules compelling work paper retention of at least seven years, second partner review, and the inclusion in audit reports of a description of the scope of the auditor's testing of a company's internal controls and the results of such testing.

Board Inspections and Disciplinary Authority

Section 104 of the Act authorizes the Board to conduct annual inspections of the larger registered public accounting firms (i.e., those which regularly provide audit reports for more than 100 public companies) and less frequent inspections (but no less than once every three years) of smaller firms. The inspections will include a review of selected audit engagements, including engagements that are the subject of litigation. Inspection reports prepared by the Board will be available to the public, but documents provided to the Board in connection with the inspection will remain confidential.

The Board also will have responsibility under Section 105 of the Act for investigating possible violations by registered public accounting firms and their associated persons of its rules and securities law provisions relating to the auditing function. In addition, the Board will be able to impose disciplinary sanctions, including fines and temporary or permanent bars on future auditing of public companies.

F. Broaden Sanctions for Wrongdoing

Enhancement of Criminal Sanctions

The Act broadens the criminal sanctions available for securities law and related violations by (i) increasing penalties for pre-existing crimes, (ii) creating new criminal offenses, and (iii) lengthening federal sentencing guidelines. In addition, the Act expands the SEC's enforcement authority in certain respects.

Increased Penalties for Pre-Existing Crimes

Section 903 of the Act increases the maximum imprisonment time for mail and wire fraud from five years to 20 years. Section 1106 of the Act raises the maximum penalties for violations of the Exchange Act in three respects: prison time from 10 years to 20 years, individual fines from $1 million to $5 million, and fines for entities from $2.5 million to $25 million. Section 904 of the Act increases the criminal sanctions for violations of the reporting and disclosure provisions of ERISA by upgrading the violations from misdemeanors to felonies, and by increasing the maximum penalties as follows: prison time from one year to 10 years; individual fines from $5,000 to $100,000, and fines for entities from $100,000 to $500,000. Given that maximum penalties rarely are imposed and that prosecutors usually charge numerous counts when they bring a prosecution, these changes in the statutory maximums are principally of symbolic importance. The increased Guidelines sentences (discussed below), however, could have a significant impact on the sentences actually imposed for criminal violations of the securities laws.

New Criminal Offenses

The Act creates a number of new criminal offenses:

- ***Securities fraud***. Section 807 of the Act creates a new federal criminal prohibition against fraud in connection with securities registered under Section 12 of the Exchange Act. It is unclear what impact (apart from the increase in the maximum penalty mentioned above) this new provision will have, given that most or all of the conduct at issue has been able to be prosecuted as a criminal violation of the antifraud provisions of the securities laws.
- ***Obstruction of justice by destroying documents to impede federal investigation***. Section 802 of the Act defines a new obstruction of justice offense for knowingly destroying or altering documents with the intent of impeding a federal investigation. The impact of this provision is unclear (apart from the increased penalty noted previously), since destruction of documents with the intent to obstruct a federal investigation was already criminal under existing law. However, the language of the new statute is broad, and likely will be given an expansive interpretation, whereas existing laws have been construed narrowly. In particular, it is important to note that the new provision makes criminal the destruction, alteration or covering up of any document in contemplation of any federal investigation, whereas existing law requires an ongoing investigation before any criminal charge can be brought.

- ***Obstruction of justice by destroying corporate audit records***. Section 802 of the Act creates a second new obstruction of justice offense applicable to the destruction of corporate audit or review records before five years have elapsed from the end of the period in which the audit or review was completed. In addition, Section 802 requires accounting firms to retain audit workpapers for five years, and directs the SEC to adopt regulations specifying the other records that accounting firms must maintain. Typically, accounting firms retain their formal workpapers for at least five years, so the audit workpapers retention requirement is unlikely to have much impact. But SEC regulations requiring the retention of other records (coupled with the threat of criminal sanctions) may cause accounting firms to retain many more documents than has been customary. These documents may prove to be a fertile hunting ground for both criminal investigators and private plaintiffs seeking discovery as to the audited company's accounting practices.
- ***Tampering with a record or otherwise impeding an official proceeding***. Section 1102 of the Act makes it a crime to alter, destroy or conceal a document or other object in order to impair the object for use in an official proceeding, or to otherwise obstruct or impede an official proceeding. Mere attempts to engage in the above practices are likewise considered to be crimes. This provision clearly was directed at the type of document shredding that occurred in the Enron situation.
- ***Failure of corporate officers to properly certify corporate periodic reports***. As previously discussed on pages 7-8, Section 906 subjects the CEO and CFO of public companies to potential criminal penalties if they fail to properly certify the periodic reports filed by them with the SEC.
- ***Attempts and conspiracies to commit criminal fraud***. Section 902 of the Act states that any attempt or conspiracy to commit a criminal fraud offense will be subject to the same penalties that would have applied if the attempt or conspiracy had succeeded.
- ***Retaliation against informants***. Section 1107 expands the federal prohibition against witness retaliation by specifically prohibiting interference with the lawful employment or livelihood of any informant in a federal criminal case.

Lengthened Federal Sentencing Guidelines

Sections 805, 905 and 1104 of the Act require the U. S. Sentencing Commission to review and amend the federal sentencing guidelines within 180 days after enactment to ensure that the penalties for certain offenses are consistent with the Act and sufficient to deter and punish. Section 805 relates to obstruction of justice (particularly obstruction due to destruction of documents), fraud that endangers the financial security of a large number of victims, and corporate and organizational criminal misconduct. Section 905 relates to securities fraud and ERISA offenses. And Section 1104 relates to securities and accounting fraud, including fraud by officers and directors of publicly traded corporations.

It appears likely that the Sentencing Commission will increase the applicable guidelines, which could have a significant impact on the sentences imposed on wrongdoers. It also is important to note Congress's directive to the Sentencing Commission to review the guidelines for corporate and organizational offenses. This review could lead to a significantly increased focus on prosecuting the corporation itself, and increase the penalties imposed on the corporation.

Expanded SEC Enforcement Authority

Sections 305 and 1103 of the Act provide the SEC with additional powers to address criminal activity involving securities. Section 305 allows the Commission to seek equitable relief in any federal proceeding that may be appropriate or necessary for the benefit of investors. And Section 1103 enables the SEC to petition a federal district court for a 45-day temporary freeze of the assets of a public company where the Commission believes it is likely that the company will make extraordinary payments (including compensation) to any of its directors, officers, partners, controlling persons, agents or employees.

Enhancement of Civil Sanctions

The Act broadens the civil sanctions available for redressing securities law violations by (i) extending the statute of limitations for securities fraud, (ii) vesting the SEC with power to bar directors and officers from serving in similar public company positions in the future, and (iii) prohibiting the discharge in bankruptcy proceedings of debts relating to securities fraud.

Extended Statute of Limitations

Section 804 of the Act extends the statute of limitations in private actions for securities fraud to two years from discovery of the violation (instead of one year) or five years after the violation occurred (instead of three years). The extension applies only to suits instituted after enactment of the Act. This change will significantly increase the exposure of parties involved in securities activities to potential lawsuits.

Ability to Bar Directors and Officers

Section 1105 of the Act grants authority to the SEC in a cease-and-desist proceeding to prohibit any person who has violated the antifraud provisions of Section 10(b) of the Exchange Act from serving as an officer or director of a public company. Until this provision was enacted, the SEC could obtain a bar of this nature only by petitioning a U. S. District Court.

Non-Discharge in Bankruptcy of Fraudulently Incurred Debts

Section 803 of the Act amends the federal bankruptcy laws to preclude a debtor from obtaining a discharge in bankruptcy proceedings of debts incurred in violation of any federal or state securities law or regulation.

G. Miscellaneous Matters Warranting Attention

Analyst Conflicts of Interest

In an effort to improve the objectivity of analyst research and provide investors with more useful and reliable information, Section 501 of the Act mandates that the SEC, or a national securities exchange or Nasdaq (if designated by the SEC), adopt rules within one year of enactment addressing the conflicts of interest that arise when securities analysts recommend equity securities in research reports and public appearances.

Mandated Studies

The Act mandates a multitude of studies with specific deadlines that are set forth in the next section Among the studies not already mentioned are those which are to examine

- The consolidation of public accounting firms since 1989
- The role and function of credit rating agencies
- Enforcement actions during the past five years involving violations of the reporting requirements or restatements of financial statements
- The extent to which investment banks and financial advisors may have assisted public companies in manipulating earnings and hiding their true financial condition

SEC Resources and Authority

Section 601 of the Act increases the SEC's budget for Fiscal 2003 dramatically (i.e., by 77% to $776 million). This will enable the SEC staff to review more filings, perform more investigations, and assume a greater role in the oversight of auditors.

The SEC also gained additional authority as a result of the Act:

- Section 108 allows the SEC to recognize accounting principles as being within GAAP where they are established by a "standard setting body." The SEC will make the determination whether a particular entity qualifies as a standard setting body.
- Section 602 enables the SEC to censure persons, and preclude them from appearing or practicing before it, if it finds they lack the qualifications to represent others, have engaged in unethical or improper professional conduct, or have willfully violated the securities laws.
- Section 604 permits the SEC to consider orders of state securities commissions when contemplating disciplinary action against brokers or dealers.

EFFECTIVE DATES

Provisions that are effective immediately

- CEO and CFO certifications of periodic reports that contain financial statements (§ 906)
- Forfeiture of CEO and CFO bonuses and disgorgement of trading profits after accounting restatements due to misconduct (§ 304)
- Prohibition of new loans by company to directors and executive officers (§ 402)
- Grant of protections to employees against retaliatory actions for providing information regarding perceived violations of securities or antifraud laws (§ 806)
- Grant of authority to SEC to prohibit certain individuals from serving as an officer or director of a public company (§ 1105)
- Directive that SEC review each public company's filings at least every three years (§ 408)
- Directive that SEC issue rules mandating "rapid and current" disclosure of information concerning material changes in company's financial condition or operations (§ 409)
- Non-discharge in bankruptcy of debts arising under securities law claims (§ 803)
- Extension of statute of limitations for private securities fraud actions commenced after date of enactment (§ 804)

- Creation of new criminal offenses for destroying, altering or falsifying records in Federal investigations and bankruptcy and destroying corporate audit records, as well as directive to U. S. Sentencing Commission to amend the Federal Sentencing Guidelines and related policy statements to implement the new offenses and penalties (§§ 801-807, 901-906 and 1101-1107)

Provisions with 30-day triggers

- Directive to SEC to issue rules requiring CEO and CFO certifications of certain corporate records and information in each annual or quarterly report, and indicating that incorrect certifications could subject certifying CEO or CFO to civil and criminal liability (§ 302)
- Acceleration of deadline for insiders to file transaction reports under Section 16 to two business days after execution of transaction (§ 403)

Provisions with 90-day triggers

- Directive to SEC to propose rules within 90 days and issue final rules within 180 days requiring public companies to disclose whether a "financial expert" serves on their audit committees and if not, why not (§ 407)
- Directive to SEC to propose rules within 90 days and issue final rules within 180 days requiring public companies to disclose in their periodic reports whether they have adopted a code of ethics for senior financial officers and if not, why not, and to disclose immediately (on Form 8-K or otherwise) any change in or waiver of the code of ethics for senior financial officers (§ 406)
- Directive to SEC to propose rules within 90 days and issue final rules within 270 days making it unlawful for any officer or director of a public company, or persons acting under their direction, to exert improper influence on the conduct of an audit for the purpose of rendering the company's financial statements materially misleading (§ 303)

Provisions with 180-day triggers

- Bar against directors and officers of public companies from purchasing or selling stock during pension fund blackout periods, subject to certain limited exceptions (§ 306)
- Directive to SEC to issue rules within 180 days requiring attorneys for public companies to report evidence of material violations of securities laws or breaches of fiduciary duties to designated parties at the company (§ 307)
- Directive to SEC to issue rules within 180 days prohibiting the disclosure in periodic reports or in any public disclosure (including a press release) of pro forma financial information that is not reconciled with GAAP (§ 401)
- Directive to SEC to issue rules within 180 days providing that each periodic report disclose all material off-balance sheet transactions, arrangements and obligations and other relationships with unconsolidated entities or other persons (§ 401)
- Directive to U. S. Sentencing Commission to review and amend federal sentencing guidelines within 180 days to ensure that the penalties for certain offenses are consistent with the Act and sufficient to deter and punish (§§ 805, 905, 1104)

Provisions with 270-day triggers

- Directive to SEC to issue rules within 270 days requiring audit committees composed of independent, outside directors to hire and oversee auditors (§ 301)
- Directive to SEC to determine within 270 days whether the Public Company Accounting Oversight Board is organized and has the capacity to carry out the requirements of the Act (§§ 101 and 107)

Provisions with one-year triggers

- Requirement that Section 16 transaction reports be filed electronically, and that SEC and reporting person's company (if it has a website) publish the reports on the Internet within one business day following the filing (§ 403)
- SEC to complete a study on special purpose entities within one year after the adoption of off-sheet balance disclosure rules (§ 401)
- SEC, or national securities exchange or Nasdaq (if designated by SEC), to adopt rules addressing analyst conflicts of interest (§ 501)
- Comptroller General to complete study of effects of requiring mandatory rotation of auditing firms (207)

Provisions with triggers beyond one year

- Requirement that firms which audit public companies must be registered with the Public Company Accounting Oversight Board within 180 days after SEC determination (which is to occur within 270 days after enactment) that Board is organized and has the capacity to carry out the requirements of the Act, at which time such audit firms would be precluded from contemporaneously providing certain specified non-audit services, with the provision of other non-audit services to be preapproved by the audit committee (§§ 201, 202)

For more information about the matters discussed in this SEC Update, please contact the Hogan & Hartson L.L.P. attorney with whom you work, or any of the attorneys below who contributed to this Update, or who are part of our securities group listed at http://www.hhlaw.com/secattorneys/.

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SEC update

NYSE and Nasdaq Take Further Action on Corporate Governance Proposals

August 7, 2002

Both the New York Stock Exchange and the Nasdaq Stock Market recently took additional action regarding their corporate governance proposals outlined in our June 12, 2002 SEC Update. On July 24th, Nasdaq's board of directors approved an expanded set of corporate governance proposals, supplementing an earlier set of proposals announced in June. On August 1st, the NYSE board of directors approved a series of rule changes that originally were proposed in June, with some modifications and clarifications in the final rules to reflect the recent passage of the Sarbanes-Oxley Act of 2002 (see our July 31, 2002 SEC Update). The SEC must publish for comment and formally approve the NYSE and Nasdaq rules before they will become effective, typically a 30 to 120 day process. Some of the rules will be effective immediately, while others will have extended phase-in periods from their initial effective date. If adopted, the proposals would impose significant new corporate governance requirements on most publicly traded companies, as explained below.

NYSE Rules

The rules approved by the NYSE implement the final recommendations of its Corporate Accountability and Listing Standards committee outlined in our previous Update. Briefly, the rules would do the following:

- **Increase board independence.** Independent directors would have to comprise a majority of the board and would have to convene regular "executive sessions" without any members of management present.

- **Tighten the definition of "independent" director.** A director would be deemed "independent" only if the board affirmatively determines that the director has no material relationship with the company, either directly or as a partner, shareholder or officer of an organization that has a relationship with the company. A five-year "cooling-off" period would apply to (i) former employees of the company or its independent auditor, (ii) former employees of another company whose compensation committee includes an officer of the listed company, and (iii) immediate family members of the foregoing persons. The NYSE clarified that a company could adopt and disclose categorical standards to assist it in determining director independence and make a general disclosure if a director satisfies the standards. A specific explanation of the company's determination would be required only for directors that do not satisfy the standards.
- **Increase audit committee independence.** The audit committee would have to be composed entirely of independent directors and be chaired by an individual possessing accounting or financial management experience. The audit committee charter would have to be publicly disclosed. In addition to the director independence standards, a member of the audit committee could not receive any compensation from the company, including direct or indirect fees as a consultant or as a legal or financial advisor, other than compensation for service as a director or committee member, and could not vote in audit committee proceedings if associated with a shareholder owning 20% or more of the company's equity. The NYSE dropped its original proposal that the audit committee be given sole responsibility for hiring and firing the company's independent auditors, and for approving any significant non-audit work by the auditors, noting that these requirements are contained in the Sarbanes-Oxley Act.
- **Impose new requirements for nominating and compensation committees.** NYSE companies would have to establish nominating and compensation committees (although those specific titles would not be required), and only independent directors could serve as members of these two committees. Companies would have to adopt and publicly disclose the charters for these committees.
- **Require adoption of corporate governance guidelines.** A NYSE company would be required to adopt and disclose corporate governance guidelines dealing with a variety of topics, including management succession and the following matters involving directors: (i) qualification standards, (ii) responsibilities, (iii) access to management and independent advisors, (iv) compensation, (v) orientation and continuing education, and (vi) annual performance evaluation of the board.
- **Require a company code of conduct.** A company also would have to adopt and publish a code of business conduct and ethics, and disclose promptly any waivers of the code that are granted to directors or executive officers. The NYSE also urged listed companies to act voluntarily to establish orientation programs for new board members and continuing education forums for current and newly elected directors. The NYSE plans to work with leading corporate governance authorities to establish its own "Directors Institute."
- **Require shareholder approval for adoption of stock plans.** A shareholder vote would be required for the approval of all equity-based compensation plans, although the final rules exclude from the shareholder approval requirement employment inducement options, option plans acquired through a merger, and tax-qualified plans such as ESOPs and 401(k) plans. Brokers would not be permitted to vote proxies on such plans without specific instructions from their customers.

- **Require CEO certification.** The CEO would be required to certify each year that he or she is not aware of any violations of NYSE listing standards, and this certification would have to be included in the company's annual report. Companies also would be required to have an internal audit function. The original proposal for a more detailed CEO certification regarding the quality of corporate disclosure was not adopted, in view of recent SEC action in this area and the provisions of the Sarbanes-Oxley Act.
- **Permit public reprimand letters.** The new rules would give the NYSE authority to issue a public reprimand letter to listed companies that violate its corporate governance standards, in addition to the option of delisting the company.
- **Clarify application of governance standards to non-U.S. companies.** NYSE-listed foreign private issuers would have to disclose any significant variations in their corporate governance practices from NYSE standards, but the board clarified that it expects only a brief general summary of the major differences, not a detailed "laundry list" of variations.

Nasdaq Rules

The expanded list of rule proposals approved by the Nasdaq board of directors is similar to the NYSE proposals, and also reflects passage of the Sarbanes-Oxley Act. The proposals would do the following:

- **Increase board independence.** The majority of the board would have to be independent, and the independent directors would be required to meet regularly in separately convened sessions.
- **Tighten the definition of "independent" director.** Payments other than for board services made to, or on behalf of, a director or a member of the director's family in excess of $60,000 would disqualify a director from being deemed independent. This provision would encompass political contributions exceeding $60,000, as well as contributions by the company to a charity for which one of its directors serves as an executive officer if the contribution exceeds the greater of $200,000 or 5% of either the company's or the charity's gross revenues. A shareholder owning or controlling 20% or more of the company's voting securities would not be considered independent, nor would any relative of an executive officer of the company or its affiliates, or a former partner or employee of the company's outside auditor if that person worked on the company's audit engagement. A three-year "cooling off" period would apply to directors who are not independent due to (i) interlocking compensation committees; (ii) the receipt by the director or a family member of any payments in excess of $60,000 other than for board service; or (iii) having worked on the company's audit engagement.
- **Increase audit committee responsibilities and independence.** All related party transactions would have to be approved by the audit committee or a comparable body of the board of directors. The audit committee would have the sole authority to hire and fire the outside auditors and would have to approve, in advance, all services rendered by the auditor that are not related to the audit. Audit committees would have authority to consult with and retain legal, accounting and other experts in appropriate circumstances and the committee members would have to be able to read and understand financial statements at the time of their appointment. A non-independent director could serve on the audit committee in "exceptional and limited circumstances" but only for two years and could not serve as chair of the committee.

- **Impose new requirements for nominating and compensation committees.** Director nominations would have to be approved by either an independent nominating committee or a majority of the independent directors. A single non-independent director could serve on the nominating committee if (i) the individual owns more than 20% of the company's securities, even if he or she also is an officer of the company; or (ii) the person is serving due to "exceptional and limited circumstances" and has done so for no more than two years. CEO compensation would have to be approved by either an independent compensation committee or a majority of the independent directors meeting in executive session. Compensation of other executive officers would have to be approved in the same manner, except that the CEO could be present in any executive session of independent directors. A single non-independent director could serve on the compensation committee due to "exceptional and limited circumstances," but for no more than two years.
- **Require a company code of conduct.** All companies would be required to establish a code of conduct addressing, among other things, conflicts of interest and compliance with applicable laws, rules and regulations, with a compliance mechanism. Waivers of the code could be granted only by independent directors, and any waivers granted to directors and executive officers would have to be disclosed. Nasdaq also plans to mandate continuing education for all directors and intends to develop rules governing this requirement.
- **Require shareholder approval for adoption or material modification of stock plans.** The shareholder approval requirement would apply to all stock plans, with limited exceptions. A company could continue to make inducement grants to new executive officers, but would be required to obtain the approval of either the independent compensation committee or a majority of the company's independent directors. An exception also would exist for ESOPs, for the assumption of pre-existing option grants in connection with a merger or acquisition, and for pre-existing plans unless there is a material modification to the plan.
- **Require announcement of audit opinion with "going concern" qualification.** The company would be required to issue a press release if it receives an audit opinion with a going concern qualification. This would be in addition to including the opinion in a Form 10-K report.
- **Accelerate disclosure of insider stock transactions.** Companies would be required to disclose director or officer transactions in company stock within two business days if the transaction exceeds $100,000, or not later than the second business day of the following week if the transaction is less than $100,000.
- **Modify rules for disclosure of material information.** Nasdaq also has harmonized its rules on the disclosure of material information, so they will be satisfied by any disclosure method that complies with the SEC's Regulation FD.
- **Clarify delisting penalty.** The Nasdaq rules clarify that a company could be delisted from Nasdaq if the company makes a material misrepresentation or omission to Nasdaq.
- **Clarify application of governance and quantitative listing standards to non-U.S. companies.** Nasdaq currently will exempt non-U.S. companies from its corporate governance rules if those rules would require the company to do anything contrary to the laws, rules, regulations or generally accepted business practices of the company's home country. The new rules would require non-U.S. companies to disclose these exemptions at the time they are received and annually thereafter, as well as any alternative measures

taken in lieu of the Nasdaq requirement. Non-U.S. companies would have to file, with both Nasdaq and the SEC, an English language version of all interim reports filed in their home country and, at a minimum, a semiannual report containing an interim balance sheet and statement of operations. The financial statements in the semiannual report would not have to be prepared in accordance with U.S. GAAP. After an 18-month phase in period, non-U.S. companies would have to satisfy the same SmallCap initial and continued listing requirements for bid price and market capitalization that currently apply to U.S. companies, and the shares underlying American Depositary Receipts of SmallCap issuers would have to satisfy the same publicly held shares and shareholder requirements that apply to U.S. companies.

What to Expect

Even though new rules adopted by the NYSE and Nasdaq must be approved by the SEC after a mandatory period for public comment, the rules are significantly closer to final adoption. The SEC is unlikely to favor any significant changes in the rules and even more unlikely to support changes that will relax any of the new requirements. As the NYSE has indicated, the new rules could be in place as early as this fall, although certain of the changes have extended phase-in periods. In particular, NYSE-listed companies would have 24 months to comply with the requirement for boards to have a majority of independent directors. The deadline for compliance with Nasdaq's comparable independence requirement is immediately following the first annual meeting of shareholders held at least 120 days after the SEC approves the rules. For calendar year Nasdaq companies, that could be as early as next spring's annual shareholders meeting, and those companies should begin reviewing any circumstances that might impair a director's independence under the new rules and begin identifying likely new director candidates. As indicated in our June 12th SEC Update, companies also may want to consider taking action consistent with the proposals even before they become mandatory, to help restore investor confidence and improve institutional investors' perception of the company.

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STATUS OF FEDERAL LEGISLATION AFFECTING CalSTRS

CORPORATE GOVERNANCE

BILL/ SPONSOR	STATUS (9/9/02)	SUMMARY
S. 2460 (Levin)	Senate Committee on Banking, Housing, and Urban Affairs	Would guarantee persons who invest in publicly held companies would receive accurate information about the financial condition of such companies so they can make fully informed investment decisions and increase the independence of the Financial Accounting Standards Board

INVESTOR PROTECTION AND ACCOUNTING OVERSIGHT

BILL/ SPONSOR	STATUS (9/9/02)	SUMMARY
* H.R. 3763 (Oxley)	Became Public Law No: 107-204	Would establish an accounting oversight board, promote greater independence of outside auditors and provide for reforms in corporate governance and financial disclosure.
S. 2004 (Dodd)	Senate Committee on Banking, Housing, and Urban Affairs	Would improve quality and transparency in financial reporting and independent audits and accounting services, to designate an Independent Public Accounting Board, enhance the standard setting process for accounting practices, and improve Securities and Exchange Commission resources and oversight.
*S. 2673 (Sarbanes)	Incorporated into H.R. 3763 (P.L. 107-204)	Would establish an accounting oversight board, promote greater independence of outside auditors and provide for reforms in corporate governance and financial disclosure.

STATUS OF FEDERAL LEGISLATION AFFECTING CalSTRS

PENSION SECURITY

BILL/ SPONSOR	STATUS (9/9/02)	SUMMARY
H.R. 2269 (Boehner)	Senate Committee on Finance	Would amend ERISA and the Internal Revenue Code to promote the provision of retirement investment advice to workers managing their retirement income assets.
H.R. 3657 (Miller)	House Subcommittee on Employer-Employee Relations	Would amend ERISA to provide for improved disclosure, diversification, account access, and accountability under individual account plans.
H.R. 3669 (Portman / Cardin)	Committee of the Whole House	Would amend the Internal Revenue Code to empower employees to control their retirement savings accounts through new diversification rights, new disclosure requirements, and new tax incentives for retirement education.
*H.R. 3762 (Boehner-Thomas)	Senate Committee on Health, Education, Labor, and Pensions	Would amend ERISA and the Internal Revenue Code to provide additional protections to participants and beneficiaries in individual account plans from excessive investment in employer securities, promote the provision of retirement investment advice to workers managing their retirement income assets, and would amend the Securities Exchange Act to prohibit insider trades during any suspension of the ability to plan participants or beneficiaries to direct investment away from equity securities of the plan sponsor.
S. 1919 (Wellstone)	Senate Committee on Health, Education, Labor, and Pensions	Would amend ERISA to provide for improved disclosure, diversification, account access, and accountability under individual account plans.
S. 1971 (Grassley)	Committee of the Whole Senate	Would amend the Internal Revenue Code and ERISA to ensure that pension assets are adequately diversified and by providing workers with adequate access to, and information about, their pension plans, and for other purposes.
* S. 1992 (Kennedy)	Committee of the Whole Senate	Would amend ERISA to improve diversification of plan assets for participants in individual account plans, and improve disclosure, account access, and accountability under individual account plans.
S. 2190 (Kerry-Snowe)	Senate Committee on Finance	Would amend the Internal Revenue Code and ERISA to provide employees with greater control over assets in their pension accounts by providing them with better information about investment of the assets, new diversification rights, and new limitations on pension plan blackouts.

*Key legislation on this issue

STATUS OF FEDERAL LEGISLATION AFFECTING CalSTRS

SECURITIES FRAUD LITIGATION

BILL/ SPONSOR	STATUS (9/9/02)	SUMMARY
* S. 2010 (Leahy)	Senate Committee on the Judiciary Subcommittee on Crime and Drugs	Would provide for criminal prosecution of persons who alter or destroy evidence in certain Federal investigations or defraud investors of publicly traded securities, disallow debts incurred in violation of securities fraud laws from being discharged in bankruptcy, and protect whistleblowers against retaliation by their employers.
H.R. 5118 (Sensenbrenner)	Committee on the Judiciary	Would provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies.

ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

BILL/ SPONSOR	STATUS (9/9/02)	SUMMARY
H.R. 4931 (Portman)	Committee of the Whole Senate	Would make permanent the pension and individual retirement arrangement provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001.

INTERNAL REVENUE CODE

BILL/ SPONSOR	STATUS (9/9/02)	SUMMARY
H.R. 1368 (Saxton)	Committee on Ways and Means	Would amend the Internal Revenue Code to remove the requirement of a mandatory beginning date for distributions from individual retirement plans.
H.R. 5095 (Thomas)	Committee on Ways and Means	Would amend the Internal Revenue Code to improve and simplify compliance with the internal revenue laws.
S. 2119 (Grassley)	Committee of the Whole Senate	Would amend the Internal Revenue Code to provide for the tax treatment of inverted corporate entities and of transactions with such entities.

*Key legislation on this issue

STATUS OF FEDERAL LEGISLATION AFFECTING CalSTRS

CONFIDENTIALITY OF SOCIAL SECURITY NUMBER PROVISIONS

BILL/ SPONSOR	STATUS (9/9/02)	SUMMARY
H.R. 220 (Paul)	House Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations	Would amend the Social Security Act and the Internal Revenue Code to protect the integrity and confidentiality of Social Security account numbers issued under such title, prohibit the establishment in the Federal Government of any uniform national identifying number, and prohibit federal agencies from imposing standards for identification of individuals on other agencies or persons.
H.R. 2036 (Shaw / Clay)	House Subcommittee on Financial Institutions and Consumer Credit	Would amend the Social Security Act to enhance privacy protections for individuals, and prevent fraudulent misuse of the Social Security account number.
S. 324 (Shelby)	Senate Committee on Banking, Housing, and Urban Affairs	Would amend the Gramm-Leach-Bliley Act, to prohibit the sale and purchase of the social security number of an individual by financial institutions, and include social security numbers in the definition of nonpublic personal information.
S. 451 (Nelson)	Senate Committee on Finance	Would establish civil and criminal penalties for the sale or purchase of a social security number.
S. 848 (Feinstein)	Committee on Finance Subcommittee on Social Security and Family Policy	Would limit the misuse of Social Security numbers, to establish criminal penalties for such misuse.
S. 1014 (Bunning)	Senate Committee on Finance	Would amend the Social Security Act to enhance privacy protections for individuals, and prevent fraudulent misuse of the Social Security account number.

*Key legislation on this issue

STATUS OF FEDERAL LEGISLATION AFFECTING CalSTRS

SOCIAL SECURITY OFFSET REDUCTION PROVISIONS

BILL/ SPONSOR	STATUS (9/9/02)	SUMMARY
H.R. 664 (Jefferson)	House Subcommittee on Social Security	Would amend the Social Security Act to provide that the reductions in Social Security benefits which are required in the case of spouses and surviving spouses who are also receiving certain government pensions shall be equal to the amount by which the total amount of the combined monthly benefit (before reduction) and monthly pension exceeds $1,200.
H.R. 848 (Sandlin)	House Subcommittee on Social Security	Would amend the Social Security Act to eliminate the Windfall Elimination Provision.
H.R. 1073 (Frank)	House Subcommittee on Social Security	Would amend the Social Security Act to restrict the application of the Windfall Elimination Provision to individuals whose combined monthly income from benefits under such title and other monthly periodic payments exceed $2,000 and to provide for a graduated implementation of such provision on amounts above $2,000.
H.R. 2462 (Brady)	House Committee on Ways and Means	Would amend the Internal Revenue Code to provide an exclusion from gross income for that portion of a governmental pension received by an individual which does not exceed the maximum benefits payable the Social Security Act which could have been excluded from income for the taxable year.
H.R. 2638 (McKeon)	House Subcommittee on Social Security	Would amend the Social Security Act to repeal the Government Pension Offset and Windfall Elimination Provision.
S. 611 (Mikulski)	Senate Committee on Finance	Would amend the Social Security Act to provide that the reductions in Social Security benefits which are required in the case of spouses and surviving spouses who are also receiving certain Government pensions shall be equal to the amount by which two-thirds of the total amount of the combined monthly benefit (before reduction) and monthly pension exceeds $1,200, adjusted for inflation.
S. 1523 (Feinstein)	Senate Committee on Finance	Would amend the Social Security Act to repeal the Government Pension Offset and Windfall Elimination Provision.

*Key legislation on this issue

STATUS OF FEDERAL LEGISLATION AFFECTING CalSTRS

INDIVIDUAL ACCOUNT PROVISIONS

BILL/ SPONSOR	STATUS (9/9/02)	SUMMARY
H.R. 3497 (Shaw)	House Committee on Ways and Means	Would amend the Social Security Act and the Internal Revenue Code to create personal Social Security guarantee accounts ensuring full benefits for all workers and their families.
H.R. 3535 (DeMint)	House Committee on Ways and Means	Would amend the Social Security Act and the Internal Revenue Code to create of individual Social Security accounts ensuring full benefits for all workers and their families.

ADMINISTRATIVE PROVISIONS

BILL/ SPONSOR	STATUS (9/9/02)	SUMMARY
H.C.R. 120 (Green)	House Subcommittee on Social Security	Would express the sense of the Congress that Social Security reform measures should not force State and local government employees into Social Security coverage.
H.C.R. 229 (Graves)	House Subcommittee on Social Security	Would express the sense of the Congress that any reforms of the Social Security program not include mandatory coverage of State and local employees.
H.R. 4069 (Shaw-Matsui)	Senate Finance Committee	Would amend the Social Security Act to provide for miscellaneous enhancements in Social Security benefits.
S. 2533 (Smith)	Senate Finance Committee	Would amend the Social Security Act to provide for miscellaneous enhancements in Social Security benefits.

MEDICARE

BILL/ SPONSOR	STATUS (9/9/02)	SUMMARY
H.R. 4954 (Johnson)	Committee of the Whole Senate	Would amend the Social Security Act to provide for a voluntary program for prescription drug coverage under the Medicare Program, and modernize and reform payments and the regulatory structure of the Medicare Program.

*Key legislation on this issue